



THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

May 9, 2001

The Honorable John D. Dingell
Ranking Member
Committee on Energy and Commerce
2322 Rayburn House Office Building
U.S. House of Representatives
Washington, DC 20515-6115

Dear Congressman Dingell:

I am pleased to respond to your letter dated November 13, 2000 to former Chairman Levitt requesting that the Commission submit a follow-up progress report regarding investor protection issues raised by on-line trading. Since our November 3, 2000 progress report, the staff of the Commission's Office of Compliance Inspections and Examinations has concluded its review of broker-dealers offering online trading and issued a report entitled, Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations (copy attached). Relevant portions of this report and the status of other Commission initiatives regarding on-line trading are summarized in the attached memorandum prepared by the Division of Market Regulation.

If you have any questions, please do not hesitate to contact me or Bob Colby, Deputy Director of the Division of Market Regulation, at (202) 942-0094.

Sincerely,

A handwritten signature in cursive script, reading "Laura S. Unger".

Laura S. Unger
Acting Chairman

Attachments

Similar letters sent to:
The Honorable Ron Klink
The Honorable Edward J. Markey
The Honorable Edolphus Towns

MEMORANDUM

TO: Laura S. Unger, Acting Chairman

FROM: Robert L.D. Colby *BC*
Deputy Director, Division of Market Regulation

DATE: May 8, 2001

RE: On-line Trading

In a memorandum dated November 2, 2000, Annette Nazareth outlined the initiatives that the Securities and Exchange Commission ("SEC" or "Commission") and the National Association of Securities Dealers ("NASD") had undertaken to assess and improve the current investor protection safety net with regard to on-line trading. In particular, she noted that: (i) the Office of Compliance Inspections and Examinations ("OCIE") was conducting, and would soon publish, a study assessing the quality of disclosure, operational capability, and security precautions taken by broker-dealers offering on-line trading; (ii) the Division of Market Regulation would, based in part on the findings of the study, consider proposing operational capability standards for all broker-dealers; (iii) the Commission had proposed a rule requiring broker-dealers to disclose their order routing practices for trade executions; and (iv) the NASD had filed a rule proposal that would require its member firms to improve margin disclosure. The General Accounting Office's report, On-Line Trading: Better Investor Protection Needed on Brokers' Web Sites, May 9, 2000 ("GAO Report") recommended several of these initiatives. In response to a request by Representatives Dingell, Klink, Markey, and Towns for a progress report, the following is an update on the status of these and other related initiatives.

1. Study by the Office of Compliance Inspections and Examinations of Broker-Dealers Offering On-line Trading

On January 25, 2001, OCIE published its study of on-line broker-dealers entitled Examinations of Broker-Dealers Offering Online Trading: Summary of Findings and Recommendations ("OCIE Study") (copy attached).¹ In determining the scope of review, the OCIE Study took into account investor complaints received by the SEC's Office of Investor Education and Assistance concerning broker-dealers offering on-line trading.²

¹ The OCIE Study is also available on-line at www.sec.gov/news/studies/online.htm.

² As noted in a letter dated February 27, 2001 to Congressman Dingell from Steven B. Caruso, Maddox, Koeller, Hargett & Caruso, investor complaints to the SEC's Office of Investor Education and Assistance regarding on-line trading do not necessarily reflect the level of

Among other things, the OCIE Study assessed the quality of disclosure and investor education provided by on-line firms on their web sites; the methods on-line firms were using to ensure sufficient operational capability to serve their customers; and approaches on-line firms were taking to address security and privacy issues.³ OCIE's findings regarding these issues are discussed below.

A. Disclosure and Education

As described in the OCIE Study, OCIE staff found inconsistencies in the quality of disclosure and investor education provided by on-line broker-dealers' web sites and concluded that enhanced disclosure in certain areas would respond to many customer complaints. Based partly on current practices of certain on-line broker-dealers, OCIE concluded that, in evaluating their web sites, on-line broker-dealers should consider defining each of the terms used on the order entry page, using conspicuous plain English disclosure about the risks of securities trading; developing procedures to prevent executions of duplicate orders; and providing enhanced margin disclosure. These findings are discussed in more detail in the OCIE Study.

B. Operational Capability

The OCIE Study described OCIE's review of on-line firms' operational capability, including firms' assessments of capacity and procedures to respond to web site unavailability. The OCIE Study found that most firms had undertaken capacity assessments, although the frequency and focus of the assessments varied substantially among firms. In addition, the OCIE Study found that most firms had backup procedures, and these procedures could include measures designed to prevent web site outages (e.g., dual running sites) or measures designed to handle transactions during web outages (e.g., increasing the number of staff to take orders by phone). The OCIE Study discusses such findings in more detail.

We are encouraged by OCIE's findings that most firms take seriously their obligation to ensure operational capability. Nonetheless, we are still considering whether there is a need to establish standards in this area. For instance, we are considering additional recordkeeping and disclosure requirements in this area.

complaints that investors may make directly to the firms through which they conduct on-line trading.

³ The OCIE Study also covered issues relating to execution of customer transactions, advertising, and broker-dealer employee supervision. These issues are discussed in other parts of this memorandum where relevant.

C. Privacy and Security Measures

Pursuant to Section 504 of the Gramm-Leach-Bliley Act, the Commission adopted Regulation S-P, effective November 13, 2001, which requires registered broker-dealers, investment companies, and investment advisers to adopt policies and procedures that address administrative, technical, and physical safeguards for the protection of customer records and information. In an effort to provide further guidance to firms developing their new privacy and security procedures, the OCIE Study described issues for firms to consider as they adopt policies and procedures in anticipation of the new rule. OCIE staff evaluated the extent to which firms have implemented encryption to protect customer information sent through e-mails and web sites; firewalls to prevent intrusions into internal computer systems by unauthorized third persons; and passwords to limit access to confidential web site information. OCIE intends to look closely at how thoroughly broker-dealers are safeguarding customer records and information in examinations commencing after July 1, 2001, the date on which the Commission may begin enforcing Regulation S-P.

2. New Rule 11Ac1-6 Requiring Disclosure of Trade Execution Practices

The public, including on-line investors, will soon be given greater access to trade execution data. On November 15, 2000, the Commission adopted new Rule 11Ac1-6 under the Exchange Act, requiring improved disclosure of order routing practices by broker-dealers.⁴ Under Rule 11Ac1-6, broker-dealers that route customer orders in equity and option securities are required to make publicly available quarterly reports that identify the most significant venues to which customer orders are routed for execution. The reports are also required to disclose the nature of the broker-dealer's relationship with those venues, including the existence of any internalization or payment for order flow arrangements. In addition, the new rule requires a broker-dealer to disclose, on customer request, where it routed a customer's individual orders for execution. The new rule takes effect on July 2, 2001, with first quarterly reports required to be publicly available by the end of October 2001. The new rule complements a companion rule, Rule 11Ac1-5, which requires equity market centers to disclose the quality of executions they provide.

3. New NASD Rule Proposal Regarding Margin Disclosure

On April 26, 2001, the SEC approved new NASD Rule 2431, requiring all NASD member firms to deliver to their non-institutional customers a disclosure statement that discusses the operation of margin accounts and the risks associated with trading on margin.⁵ Broker-dealers may use the sample margin disclosure statement developed by the NASD or develop their own disclosure statement, provided the alternative statement is substantially similar to the NASD's sample and incorporates all of the relevant

⁴ See Securities Exchange Act Release No. 43590 (November 15, 2000); 65 FR 75414 (December 1, 2000).

⁵ See Securities Exchange Act Release No. 44223 (April 26, 2001).

concepts. In response to comment on the rule proposal, NASD Rule 2431, as approved, requires firms to explain more clearly that, upon a margin call, a customer is subject not only to liquidation of its securities accounts, but also to liquidation of the customer's other assets or property held by the broker-dealer or any of its affiliates. The margin disclosure statement must be delivered, in writing or electronically, to non-institutional customers prior to or at the opening of a margin account, and annually thereafter. The initial margin disclosure statement is required to be made in a separate document.

4. NASD Notice to Members 01-23 Regarding On-line Suitability

In April 2001, the NASD issued Notice to Members 01-23, clarifying that the NASD's general suitability rule (Rule 2310) applies to on-line trading. The NASD's general suitability rule requires a broker-dealer to conduct a suitability inquiry before recommending a securities transaction to a customer. Notice to Members 01-23 explains that a broker-dealer's duty to conduct a suitability inquiry is triggered when on-line communications between a broker-dealer and a customer constitute a recommendation to engage in a securities transaction. The Notice explains that whether a particular transaction is recommended depends on the facts and circumstances surrounding the communication. The Notice offers examples and guidelines to broker-dealers to aid them in determining whether any particular on-line communication with a customer could be considered a recommendation triggering the protections of the suitability rule.